In the Supreme Court
OF THE
United States

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OCTOBER TERM, 1940

No. 1086 107

POPE ESTATE COMPANY (a corporation),
Petitioner,

vs.

JOHN V. LEWIS, former Collector of Internal Revenue for the First Collection District of California,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit
and
BRIEF IN SUPPORT THEREOF.

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To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associate Justices of the Supreme Court of the United States:

Your petitioner, Pope Estate Company, respectfully shows that:

I.

SUMMARY STATEMENT OF MATTER INVOLVED.

This was an action at law tried by the District Court for the Northern District of California, following a waiver of jury trial, wherein petitioner, as plaintiff, sought to recover of respondent herein by way of a tax refund, the sum of $21,820.00, the amount of federal income tax paid by petitioner to respondent, under protest, for the taxable year 1933. (R. 2-8.)

The principal point involved was whether respondent had the right to collect from petitioner for said taxable year of 1933 income tax upon the value of improvements which had been placed upon petitioner's land by his lessee and became its property in prior years, upon the ground that the lease involved was terminated by forfeiture in that year, and that the value of the improvements thereupon and at that moment became income to petitioner. This point is subject to division in that one of the improvements (a hotel building) which carried the bulk of the value taxed as income was erected prior to the advent of the Sixteenth Amendment and, consequently, of the effective date of the Income Tax Act and therefore, according to petitioner's contention, its value was free from the toils of the Act.

The facts were presented to the trial court in the form of a written stipulation of the parties hereto. (R. 61-66.)

Pertinent Dates.

The selection of the following dates from the stipulation will simplify the statement of facts:

1909, March 18: The lease was entered into. Its term was 50 years. (R. 9 and 10.)

1912: The Terminal Hotel was built by the lessee; its economic value in 1933, pursuant to stipulation, being $124,635.65. (R. 65.)

1913, February 25: Income tax amendment (the Sixteenth) was added to the Constitution of the United States.

1913, October 3: Congress passed first act under the power of the Amendment, taxing incomes retroactively to March 1, 1913. (38 Sts. at Large 114.)

1915: The lessee completed the final improvement on the premises—a garage building, stipulated to have a 1933 economic value of $15,432.15. (R. 65.)

1933: The lease was terminated by forfeiture for nonpayment of rent. (R. 4, 61.)

Date of Petitioner's Title.

Under California law as applied to the terms of the lease in question, the hotel became petitioner's property in *1912,* and the garage building in 1915. (Opinion of Circuit Court of Appeals, R. 88. See brief filed in support hereof, p. 14 herein.)

Trial Court Judgment.

The trial court rendered judgment for petitioner directing refund to it of the tax paid in the sum of $21,276.49, together with interest. (R. 77.) It found that the tax to be refunded included that assessed against the value of the hotel building of $124,635.65

and that against the value of the garage of $15,432.50. (R. 70, 73, 75.)

The trial court judgment in so far as the point here involved is concerned was based upon its conclusion that petitioner lessor realized no income in 1933 by the fact that, by termination of the lease through rental default, it recovered possession of the improved premises, in that year. (R. 75.) Without doubt the trial judge was influenced somewhat to that end by the decision of the Circuit Court of Appeals of this Circuit (the Ninth) in *Miller v. Gearin,* 258 Fed. 225, which then stood unimpeached, and this court's decision in *Blatt v. United States,* 305 U. S. 267.

The Appeal.

The government (respondent herein) appealed from the judgment to the Circuit Court of Appeals for the Ninth Circuit. While the appeal was pending before one division of that court, another division thereof decided the case of *Commissioner v. Center Investment Co.,* 108 F. (2d) 190, and there held under the authority of *Miller v. Gearin* (*supra*) and the *Blatt* case (*supra*), that where the title to the improvements passed to the lessor before the taxable year, there was no income to lessor in the taxable year, through the mere fact that the lease was terminated therein.

Petitioner's Points on Appeal.

Petitioner raised two points in its brief in answer to respondent's appeal: (1) that under the authority of the above cited cases and a number of similarly decided precedents, neither the value of the hotel nor of the garage building represented income in the year the

lease was terminated, and (2) the income tax law could not in any event tax, as income, the value of improvements which became petitioner's property *prior to the advent of the Sixteenth Amendment and the income tax law.*

The Bruun Decision and Its Aftermath.

Before the appeal could be determined, this court rendered its opinion in *Helvering v. Bruun,* 309 U. S. 461, holding that where the lessor acquired title to and recovered (by forfeiture of the lease) possession of improvements placed on his land by his lessee, in the taxable year, the value thereof was income and taxable for that year. By virtue of the fact that acquisition of title and recovery of possession were simultaneous in the *Bruun* case, this court did not there decide *whether* the year of acquisition of title OR the year of the surrender of the lease (where they take place in different years) determines the year of income. Therefore, had the matter rested with the *Bruun* decision, the judgment of petitioner here might have been undisturbed on the appeal. (See opinion of Circuit Court of Appeals, R. 92.) But this court's granting of certiorari and, without a hearing, reversing: (1) the decision of the Circuit Court of Appeals of this Circuit, in *Commissioner v. Center Investment Company,* 309 U. S. 639, and (2) of the court of the Seventh Circuit, in *Commissioner v. Wood,* 309 U. S. 637, turned the tide against petitioner.

Court of Appeals Decision.

On *December 17, 1940,* the Circuit Court of Appeals reversed the judgment, and in its opinion held that the

value of both the hotel and the garage was taxable to petitioner in the year in which the lease was terminated, namely, 1933. (R. 88, 93; 116 F. (2d) 328.) It will be observed that no reference is made in that opinion to the point raised by petitioner that, the hotel having been added to and become petitioner's property prior to the Sixteenth Amendment and the taxing act, its value as income was beyond the grasp of the Act; although petitioner herein cited in its brief on appeal the decisions of this court in *Doyle v. Mitchell Bros.*, 247 U. S. 179, and *Hays v. Gauley Mt. Coal Co.*, 247 U. S. 189, which directly support petitioner's contention and have never been reversed or modified.

Petition for Rehearing.

On *January 15, 1941,* petitioner filed with the Circuit Court of Appeals, its petition for rehearing, wherein it reiterated its point that under the unmodified decisions in *Doyle v. Mitchell* (*supra*) and *Hays v. Gauley Mt. Coal Co.* (*supra*), its judgment should stand as to the refunding of the tax assessed against the value of the hotel building, to-wit: in the amount of $18,867.36, plus interest.

In the said petition for rehearing, petitioner said:

> "However, approximately ninety per cent of the tax which the District Court ordered refunded to appellee, represents tax upon an improvement to appellee's real estate made *prior to the Sixteenth Amendment,* authorizing Congress to tax incomes without apportionment among the states, an improvement which was the property of appellee at the very time, and prior to, both the adoption of the Sixteenth Amendment and the effective date of the Income Tax Act.

> We believe that as to that portion of the tax, this court should be as definitely and completely controlled by the Supreme Court decisions in *Doyle v. Mitchell Bros.* (247 U. S. 179) and the other cases hereinafter cited, as it was controlled by the *Bruun* case in determining the date of the taxpayer's *'realization'* of income."
>
> (p. 2 of Petition for Rehearing.)

The petitioner went further and called the court's attention to the fact that Congress itself has consistently so interpreted the Act, by expressly limiting the tax to income "accruing" since the effective date of the Act—March 1, 1913.

> Act of 1913—G(c): 38 St. at Large p. 166;
>
> Act of 1916—2(c): 39 St. at Large p. 756;
>
> Act of 1932—Sec. 113(a), 13 and (b)1: 26 U. S. C. A. "Internal Revenue Acts", pages 517-518.

On March 7, 1941, petitioner's petition for a rehearing of the appeal was denied by the Circuit Court of Appeals, without opinion. (R. 94.)

II.

REASONS RELIED UPON FOR ISSUANCE OF THE WRIT.

(1) The decision and opinion of the Circuit Court of Appeals in so far as it denies to petitioner a refund of the tax assessed against the value of the hotel building, erected prior to the Sixteenth Amendment, is in direct conflict with the rule laid down by this court in *Doyle v. Mitchell* (*supra*) and *Hays v. Gauley Mt.*

Coal Company (*supra*), in that it gives a stamp of approval to the taxing of an enhancement of value which antedated the Sixteenth Amendment to the Federal Constitution and accrued before the Income Tax Law went into effect.

(2) The decision misapplies the opinion of this court in *Helvering v. Bruun* (*supra*), and the court's reversal of *Commissioner v. Center Investment Company* (*supra*) and of *Commissioner v. Wood* (*supra*), by failure to recognize the fact that the decisions in those cases had nothing to do with the taxing of values which accrued *prior to the adoption of the Sixteenth Amendment.*

(3) The decision, in interpreting the Income Tax Act ignores the construction placed thereto by Congress itself, as shown hereinabove.

(4) An important question of Federal law is involved which lacks direct precedent and requires this court's determination and amplification, namely: how the rule in *Helvering v. Bruun,* 309 U. S. 461—that the value of improvements placed on leased premises by the lessee is taxable as income to lessor in *the year* in which the lessor *simultaneously* acquired the title thereto and possession thereof, on forfeiture of the lease—is to be applied to a case where the acquisition of title by the lessor took place in one taxable year and the recovery of possession of the premises in another taxable year (as in the case at bar). Upon this point no opinion has been rendered by this court, except the minute orders granting certiorari and without a hearing reversing the Court of Appeals' decisions

in *Commissioner v. Center Investment Company,* 108 Fed. (2d) 190, and *Commissioner v. Wood,* 107 Fed. (2d) 869.

Wherefore, your petitioner prays that a writ of certiorari issue under the seal of this court, directed to the Circuit Court of Appeals for the Ninth Circuit, commanding said court to certify and send to this court a full and complete transcript of the record and of the proceedings of the said Circuit Court of Appeals, had in the case numbered and entitled on its docket, No. 9534, *John V. Lewis, former Collector of Internal Revenue for the First Collection District of California, Appellant v. Pope Estate Company, a corporation, Appellee,* to the end that this cause may be reviewed and determined by this court as provided for by the statutes of the United States; and that the judgment herein of said Circuit Court of Appeals be reversed by this court and for such further relief as to this court may seem proper.

Dated, San Francisco, California,
May 19, 1941.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

OPINIONS OF COURTS BELOW.

The opinion of the Circuit Court of Appeals is found in the Record at pages 88 to 93. It is reported in 116 F. (2d) 328.

The District Court gave no written opinion. Its Findings will be found on pages 67 to 76 of the Record, and its Judgment on pages 76 to 77 thereof.

JURISDICTION.

(1) The jurisdiction of this court is invoked under section 240 of the Judicial Code, as amended by the act of February 13, 1925. (28 U.S.C.A. 347.)

(2) The trial court's judgment was entered December 26, 1939. (R. 77.)

(3) The opinion of the Circuit Court of Appeals here sought to be reviewed was rendered and dated December 17, 1940, and judgment entered thereon the same day. (R. 93, 94.) That court's denial of petitioner's petition for rehearing was had on March 7, 1941. (R. 94.)

(4) This cause being a civil case decided by the Circuit Court of Appeals, is within the jurisdiction conferred upon this court by section 240(a) of the Judicial Code.

III.

STATEMENT OF FACTS.

Petitioner, Pope Estate Company, in 1909 leased a vacant lot on Market Street, San Francisco, for approximately 50 years, from February 1, 1909, requiring the lessee to erect thereon buildings to cost at least $150,000.00. (R. 10.) The lease prohibited removal of the buildings by lessee except for the purpose of replacing them with new buildings. (R. 16.)

Construction of Improvements.

In *1912* the lessee constructed the *Terminal Hotel* on the leased land, and a *garage in 1915.* (Pleaded by

petitioner in his complaint, R. 3; admitted by respondent in stipulation, R. 61.)

Cancellation of Lease.

In early *1933* the lease was cancelled because of rent default and petitioner herein took back its property, including, of course, the buildings. (R. 4 and 61.)

The Assessment and Payment of Tax and Claim for Refund.

In regular course, petitioner filed his Federal income tax return for 1933, making therein no reference to the cancellation of the lease. The tax authorities reviewed the return, adopted the theory that petitioner should have included as income the economic value of the improvements which came into its possession on the cancellation of the lease, and, accordingly, assessed against petitioner for that year income tax on $124,635.65, as the economic value of the hotel building, and on $15,432.15 as the economic value of the garage building. (R. 65.)

Petitioner paid the tax under protest, and filed a claim for refund on the ground that it received no income by virtue of the termination of the lease, which claim was rejected. (Alleged in pars. VII and VIII of petitioner's complaint R. 6-7 and admitted by respondent R. 65), whereupon petitioner, on May 18, 1937, filed the present action to recover the taxes so paid. (R. 2, 57.)

Case Tried on Stipulation of Facts.

The facts were presented at the trial in the form of a stipulation wherein the parties presented the legal

question involved, namely, whether by virtue of the termination of the lease in 1933, petitioner received income taxable in that year, in the amount of the value of the two buildings. (R. 61 to 66.)

When Petitioner Received Title to Improvements.

That petitioner became the owner of the improvements upon completion (the hotel in 1912, and the garage in 1915), was established by the fact that the lease prohibited removal of the buildings by the lessee, and by the provisions of *sec. 1013* of the *Civil Code of California,* which reads:

> "When a person affixes his property to the land of another, without an agreement permitting him to remove it, the thing affixed * * * belongs to the owner of the land * * *."

To remove any doubt as to this proposition, respondent in its "Brief for Appellant" before the Circuit Court of Appeals, on page 3 thereof, conceded it as follows:

> "The hotel building became the property of taxpayer upon the completion of construction thereof in 1912, and the garage building likewise became its property upon completion in 1915."

Judgment went for petitioner in the trial court and respondent herein appealed. There were other items of tax assessment and claim for refund set out in petitioner's complaint and allowed in the judgment, but they were not involved in respondent's appeal and are, therefore, of no moment here. The history of that appeal is set forth in the petition herein, at pages 4 to 7.

The Points Tendered on Appeal.

On the appeal, petitioner defended the judgment as to the parts thereof here involved upon two grounds, to-wit:

(1) That petitioner, having owned the two buildings since long before the taxable year of 1933, realized no income through lessee's surrender of the lease, and that the tax on the value of both buildings was unlawful.

(2) That since petitioner acquired title to the hotel by its annexation to his realty in 1912—a year prior to the adoption of the Sixteenth Amendment—and to the effective date of the original Income Tax Act of 1913—its value was entirely beyond the scope of the Act.

On the first of the above points, petitioner's main reliance was the decision of the Court of Appeals of this Circuit (the Ninth) in *Miller v. Gearin,* 258 Fed. 225 (certiorari denied, 250 U. S. 667, which remained an authoritative precedent until overruled by this court's reversal (without hearing) of the decision in *Commissioner v. Center Investment Company,* emanating from this Circuit (108 F. (2d) 190; 309 U. S. 639), and of the decision from the Seventh Circuit in *Commissioner v. Wood,* 107 F. (2d) 869; 309 U. S. 637. However, petitioner also relied upon *Hewitt Realty v. Commissioner,* 76 F. (2d) 880, from the Second Circuit, and upon this court's opinion in the *Blatt* case, 305 U. S. 267, to the effect that there was no income in the year of the lease's forfeiture.

On the second of the above points, petitioner stood on firmer ground, relying upon the direct support of two decisions of this court, which still stand as precedents, viz.:

Doyle v. Mitchell Bros., 247 U. S. 179;
Hays v. Gauley Mt. Coal Co., 247 U. S. 189.

Respondent Collector upon his appeal relied upon one decision only (which was rendered pending the appeal) namely, this court's opinion in *Helvering v. Bruun,* 309 U. S. 461; and the Court of Appeals accepted the same authority as determinative of the appeal in this case. (R. 92.)

Petitioner's Petition to Court of Appeals for Rehearing.

The Circuit Court of Appeals having neglected to mention in its opinion the said second point of petitioner's brief, petitioner, in its petition for rehearing placed particular emphasis, upon its second of the above points, adding to its previous citations of the *Doyle* and *Hays* cases (*supra*), the decisions in *Southern Pacific v. Lowe,* 247 U. S. 330; *Lucas v. Alexander,* 279 U. S. 573, and *United States v. Cleveland,* 247 U. S. 195.

A rehearing was denied on March 7, 1941, without opinion. (R. 94.)

IV.

SPECIFICATION OF ERRORS.

The errors of the Circuit Court of Appeals upon which petitioner relies for prosecution of the writ are,

in the order in which they will be discussed in this brief:

(1) The reversal of that part of the trial court's judgment which represented a refund of the tax of $17,137.40 plus interest assessed against the value of the hotel building, violates the rule laid down by this court in decisions which stand unimpeached, in that the income in question accrued before the Sixteenth Amendment was adopted and the Income Tax Law went into effect, and was thus beyond the reach of the Income Tax law.

(2) The reversal of the trial court's entire judgment was against law, because it sustains the taxing in the taxable year 1933, of income derived by the taxpayer in previous years.

V.

ARGUMENT AND SUPPORTING AUTHORITIES.

A.

THE VALUE OF THE HOTEL BUILDING WHICH BECAME PETITIONER'S PROPERTY PRIOR TO THE ADVENT OF THE SIXTEENTH AMENDMENT AND THE INCOME TAX ACT OF 1913, CANNOT BE TAXED AS INCOME UNDER THE ACT.

(1) Reason Supporting the Rule.

It would seem reasonable that the enactment of an income tax law creating a tax on profit or gain could not go back beyond the effective date of the act to pick up gain for tax purposes. When Congress was by the

Sixteenth Amendment to the Constitution, empowered to enact, and when it did enact, the Income Tax Act of 1913, making it retroactive to March 1, 1913, it found petitioner the owner of the lot, already improved by a hotel building likewise the property of petitioner under the laws of the State of California. The enhancement in value to petitioner's land by the construction of the hotel building, had already taken place. That enhancement was not, we believe, a commodity, taxable under an act of Congress *effective after* the enhancement took place.

(2) The Supporting Authorities.

The point has been definitely determined by this court, in a number of unmodified and unconflicting decisions. In *Doyle v. Mitchell* (*supra*), as here, the enhancement in value took place *before* the law applicable was passed, but its "in pocket" realization did not take place until *after* the effective date of the Act—the Federal Corporation Excise Tax of 1909, which taxed incomes. Ch. 6, 36 Sts. at Large 11, 112, §38. The government, in arriving at the profit which was *in fact collected after the Act went into effect,* took, as the base, the cost of the property in a year which antedated the effective date of the Act, but this court held that the base of the tax could only be the value of the property (upon which the gain was to be predicated) on the effective date of the Act, and that the only portion of the profit realized in the taxable year which was taxable under that Act was that which represented the increase of the sales price over the

value which the property had on the effective date of the Act. To exactly the same effect, see *Hays v. Gauley Mt. Coal Co.*, 247 U. S. 189.

In the same term this court applied the rule of the *Doyle* case to the *Income Tax Act of 1913* (the Act upon which all subsequent income tax acts have fastened, as amendments thereof) in *Southern Pacific v. Lowe*, 247 U. S. 330. Prior to January 1, 1913, the Central Pacific had accumulated a surplus which was distributed in 1914, to its sole stockholder, Southern Pacific Co., and the Commissioner of Internal Revenue assuming the distribution to be 1914 income had assessed it accordingly. After calling attention to the provisions of section G(c) of the Act (which provided that while the tax was to be computed upon the entire net income accruing within each calendar year, the tax for the year 1913 should be limited to the net income which had accrued *from March 1 to December 31, 1913*), this court declared:

> "The purpose to refrain from taxing income that accrued prior to March 1, 1913, and to exclude from consideration, in making the computation, any income that accrued in a preceding calendar year, is made plain by the provision last referred to; indeed, the 16th Amendment, under which for the first time Congress was authorized to tax income from property without apportioning the tax among the states according to population, received the approval of the requisite number of states only in February, 1913.
>
> * * * * * * *
>
> Certainly the term 'income' has no broader meaning in the 1913 Act than in that of 1909 (see

> Stratton's Independence v. Howbert, 231 U. S. 399, 416, 417, 58 L. ed. 285, 293, 34 Sup. Ct. Rep. 136), and for the present purpose we assume there is no difference in its meaning as used in the two acts. This being so, we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the Act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer."

A still later holding to the same effect is that of *Lucas v. Alexander,* 279 U. S. 573, in which the taxpayer was assessed, as income in 1919, the *full amount* received by him from two endowment policies, taken out on the life of his wife in 1908. The District Court, the Court of Appeals for the Sixth Circuit, and this court agreed that "only so much of the proceeds of the policies as exceeded their surrender value on March 1, 1913, was subject to tax" (p. 575), because (to use the language of Justice Stone):

> "of the total gain received by the insured, a part is attributable to and accrued during the period before the effective date of the 16th Amendment (February 25, 1913) and of the first law (October 3, 1913) taxing the income of individuals (March 1, 1913), and, hence, for income tax purposes, must be deemed an accretion to capital not taxable by the income tax acts enacted under the 16th Amendment."

Justice Stone cited in this connection *Southern Pacific v. Lowe,* 247 U. S. 330; *Doyle v. Mitchell Bros.,*

supra, and *Lynch v. Turrish,* 247 U. S. 221. A similar holding is found in *United States v. Cleveland,* 247 U. S. 195.

(3) The Revenue Act Itself Recognizes the Limitation.

The original Act, that of 1913, required of a corporation that it pay in each year a tax on its entire income of the preceding year, and provided:

> "that for the year ending December 31, 1913, said tax shall be imposed upon its entire net income accrued within that portion of said year from March 1, 1913 to December 31, 1913, both inclusive, to be ascertained by taking five-sixths of its entire net income for said calendar year."
>
> (Sec. G(c) of the Act; 38 St. at Large 166.)

(March 1st was undoubtedly selected as a more appropriate date to work from than the actual date of the adoption of the Sixteenth Amendment, which was February 25, 1913.)

The *1916* Act read:

> "For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of gain."
>
> (Act of 1916, sec. 2(c); 39 Statutes at Large, 756.)

The *Act of 1932,* under which the assessment here involved was levied, modified the rule somewhat by providing that the "base" in the case of a capital gain

shall be the cost *or* the value on March 1, 1913, whichever is greater. (Revenue Act of 1932, sec. 113 (a) 13 and (b) 1; 26 U.S.C.A. "Internal Revenue Acts", pages 517-518.) This does not change the essence of the original Act, because if the cost should be greater than the March 1, 1913 value, no *gain* would have accrued prior to March 1, 1913; and if the value on March 1, 1913 should prove greater than the cost, then the gain between purchase and that date would not be taxed.

We therefore are confronted with the facts that:

(1) the Amendment permitting Congress to pass an income tax without apportionment was not adopted until after the value of petitioner's real estate had been enhanced by the construction of the hotel thereon.

(2) This court, in several decisions which stand unrevised and unmodified, has determined that any enhancement of value which preceded the effective date of the Act, was not taxable as income under the Act; and

(3) Congress has repeatedly declared its intention to exclude from the operation of the Act any enhancement in value antedating the effective date thereof.

(4) Bruun Decision Offers No Conflict.

There is no inconsistency between the above facts and the decision of this court in the *Bruun* case (supra). Neither that decision nor the language of the

Act prevents the collection, in one year, of a tax on gains in value accruing in another year, provided the enhancement *accrued* since March 1, 1913. Brunn did not lease his premises until *1915* and the improvement in question was of course added thereafter. (309 U. S. 464.)

In the *Bruun* case there was involved (to use the terms of section 22 of the 1932 Act) "dealings in property" during the existence of the Income Tax Act; i. e., after March 1, 1913; while in the case at bar and in the cases hereinabove cited, commencing with the *Doyle* case, the "dealings" by which the taxpayer became the owner of the property in question, *antedated the Act* and the Constitutional Amendment justifying its existence, and were for that reason beyond the pale of the Act.

The rule we rely upon cannot be avoided on the ground that, while the building became a part of the realty and enhanced its value prior to March 1, 1913, the petitioner as owner did not "realize" the gain until termination of the lease in 1933, *because* in *every case* of gain in the sale of real estate the profit is *not realized* in that sense until the sale is made, and yet if the property was acquired before the effective date of the Act, under the authorities cited, no part of the enhancement which accrued prior to March 1, 1913, is taxable under the Act. Had petitioner herein in 1933, instead of terminating the lease, sold the premises, and "realized" a profit, it would be a "realization" *in a much stronger sense* than that term is used in the *Bruun* case. Yet despite the fact that the profit would

have all been *realized* in 1933, that part of it which *accrued* prior to March 1, 1913, would not have been taxable under the Income Tax Act in the light of the existing decisions.

(5) Modification of Decree to Take Care of Point Is a Simple Matter.

The modification of the decree of the District Court in the light of this court's decisions in the *Doyle* case and the other cases cited upon this point would not be attendant with difficulty, even should this court determine that the value of the garage building erected in 1915, was income in 1933.

The only portion of the judgment attacked by respondent on his appeal therefrom is that which relates to the tax on the economic value of the two buildings, plus interest. Consequently, it would be necessary only to eliminate from the judgment the amount of the tax and interest thereon, which was assessed against the value of the garage building.

The garage building value, as assessed for tax purposes by respondent, was $15,432.50. (R. p. 73.) The corporation tax rate under the Act applicable was 13¾%. (Revenue Act of 1932, sec. 13; 26 U.S.C.A. "Internal Revenue Act", pp. 486-7.) The tax assessed against Petitioner because of the garage building was therefore 13¾% of $15,432.50, or $2121.97. Interest on that sum from the due date of the return, to-wit: March 15, 1934 to the day of the payment of the tax on June 17, 1936 (R. p. 72), amounts to $287.16.

Therefore, assuming that under the *Bruun* decision, petitioner *was* liable to tax on the value of the garage, and, under the decision in the *Doyle* case and the decisions following it, petitioner *was not* liable to tax on the value of the hotel building, the only change necessary in the judgment of the trial court would be a deduction from the principal amount thereof (namely, $21,276.49, R. p. 77), of the sum of $2409.13 (representing principal of $2121.97 plus $287.16 interest), leaving the judgment for refund in petitioner's favor of $18,867.36, plus interest from June 17, 1936, the date of the payment of the tax.

B.

THE VALUE OF BUILDINGS WHICH BECAME PETITIONER'S PROPERTY PRIOR TO 1933, IS NOT TAXABLE AS INCOME FOR 1933.

(1) Until This Court's Reversal of Bruun Decision, Trial Court Herein Was in Agreement With All Existing Decisions.

In the case at bar, as in *Miller v. Gearin* (258 Fed. 225), under the provisions of the lease as interpreted in the light of *Sec. 1013* of the Civil Code of California, the improvements to the leased realty became the property of lessors in the year of their construction, which was *not* the year in which the lease was terminated.

The court of this Circuit held in *Miller v. Gearin,* that the value of the improvements did not represent income to the lessor in the year of the termination of

the lease, and Judge Gilbert, in rendering that court's decision, ventured the dicta that *if* the value of the improvements "was income derived from the use of the property, * * * it is clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value". (258 Fed. 226.) The court denied certiorari in that case. (250 U. S. 667.)

Hence it was that the same court had no difficulty with the identical problem in *Commissioner v. Center Investment Company,* 108 Fed. (2d) 190. Judge Denman, in writing the opinion in that case, followed the lead of the *Miller v. Gearin* decision, in declaring there was no income to the lessor by the fact of termination of the lease, but disavowed any intention of determining whether there had been income to lessors in the year the improvements were erected upon the leased premises. (108 Fed. (2d) 191.) But that court then had the additional and controlling benefit of this court's opinion in the recently decided case of *Blatt v. U. S.,* 305 U. S. 267, in which the attempt of the income tax authorities to tax a part of the value of the improvements in a year following their completion (upon the theory that the value could be spread over the years of the lease as income to lessor) was frustrated by the ruling that—

> "so far as concerns taxable income, the value of the improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. Each was an addition to capital; *not income* within the meaning of the statute." (305 U. S. 279.) (Italics ours.)

Furthermore, the Courts of Appeals of the Tenth and Eighth Circuit had furnished more recent precedents,—those of *Nicholas v. Fifteenth St. Investment Co.,* 105 Fed. (2d) 289, and *Helvering v. Bruun,* 105 Fed. (2d) 442. In the former decision it was held, as was held by the Court of the Second Circuit in *Hewitt Realty v. Commissioner,* 76 Fed. (2d) 880 at 884, that there could be no income to lessor, through lessees' erection of improvements on the leased premises, short of sale thereof—that up to that point their value constituted mere capital gain.

The Bruun Case in the Court of Appeals.

In the *Bruun* case (*supra*) the commissioner sought to tax the value of the lessee built improvements, as income to lessor in the year in which, under the express terms of the lease, the acquisition of title to the improvements by lessor, and the surrender of the lease occurred *simultaneously.*

All existing authority rejected the idea that there was income to a lessor by the fact alone that the lease terminated or was surrendered with the improvements erected by lessee still standing. So when the case reached the Court of Appeals, that court was faced with a dilemma. It had to either, (1) adopt the dicta of the *Gearin* case (*supra*) that, if the value of the improvements ever became income to the lessor, it was in the year of lessor's acquisition of title, which would have affirmed the commissioner but would have created a conflict with the *Hewitt* decision (*supra*), or (2) accept the dicta of Judge Learned Hand, in the

Hewitt decision, that there would be no income to lessor short of the sale of the premises.

However, the Court of Appeals was removed from its dilemma, by the opportune decision of this court in *Blatt v. U. S.*, 305 U. S. 267, decided December 5, 1938, which, after giving approval of the unanimous decisions of the Courts of Appeal that there was no income in the year of surrender (because of the surrender), held with Judge Hand that there was no income short of sale. So guided the Court of the Eighth Circuit decided that the lessor in the *Bruun* case received no taxable income in the year in which lessor acquired title to the improvements and recovered possession on the surrender of the lease.

Following closely upon the last mentioned decisions came that of the Court of Appeals of the Seventh Circuit in *Commissioner v. Wood,* 107 Fed. (2d) 869, in which that court held with the *Gearin, Hewitt* and *Bruun* decisions that it was unlawful to tax lessor any income in the year of the termination of the lease, and amplified the *Hewitt* decision by the statement that:

> "leasehold improvements can result in taxable income to the lessor only through increased rentals from the property after cancellation of the lease or through the sale of the property."

From the afore-described state of court decision, and with no contrary holding it is not surprising that the trial court held with the taxpayer in the case at bar, that the income, if any, derived by the lessor from lessee's improvements, was not received or taxable in the year of the lease's termination (that being a differ-

ent taxable year than that in which the improvements were erected).

(2) Bruun Decision in Our Opinion Is Not a Precedent for Court of Appeals' Reversal of Present Case.

This court's decision, on certiorari, in reversing the *Helvering v. Bruun* decision (309 U. S. 461) brought about the reversal of the decision of Circuit Court of Appeals of the Seventh Circuit in the *Wood* case, and of this Circuit (Ninth) in the *Center Investment Co.* case; and indirectly by the latter reversal, caused the Court of Appeals of this Circuit to reverse the decision of the trial court in the present case. Yet in our humble opinion, this court's holding in the *Bruun* case is not contrary to the decisions which are so reversed.

In the *Bruun* case, the title to the lessee built improvements passed to the lessor simultaneously with the termination of the lease, so there was, of course, not involved the question of whether the value of the improvements was income in the year of acquisition of title, *or* in the year of the surrender of the lease. As we read the *Bruun* decision, it goes no further than to repudiate the rule that there was no income short of sale, as advocated in the *Hewitt* and *Wood* cases and apparently the *Blatt* decision of this court, and yet Justice Roberts refrained from disavowing the *Blatt* case decision by commenting that "the circumstances of the instant case (the *Bruun* case) differentiates it from the *M. E. Blatt Co.* and *Hewitt Realty*

Co. cases." (309 U. S. 467.) The decision refers to the *Miller* and *Hewitt* cases as running counter to the Government's contention that (to quote the court):

> "that gain was realized when the respondent, through forfeiture of the lease, obtained untrammeled *title,* possession and control of the premises," (italics ours)

but we feel sure the court was referring to the language in the *Miller* case, which intimated that there might be no taxable income at all at any time, and in the *Hewitt* case that there was no income short of sale.

With no intimation in its decision in the *Bruun* case (which we have been able to discover) that it was adopting the taxable year of 1933 as the year of income, *because* it was the year of recovery of possession, *rather than the year of acquisition of title,* this court granted certiorari and *forthwith,* without hearing, reversed the Court of Appeals decisions in the *Wood* case (309 U. S. 637) and the *Center Investment Co.* case (309 U. S. 639) reciting its decision in the *Bruun* case as the reason therefor. And this despite the fact that in neither of those cases was the recovery of possession and acquisition of title by lessor simultaneous, or even in the same taxable year.

Having just had its decision in the *Center Investment Co.* reversed by the minute order of this court, in the manner hereinbefore set out, the Court of Appeals of this Circuit very naturally reversed the trial court's decision in the case at bar. On its petition for rehearing petitioner's counsel called to the court's at-

tention the fact that this court's decision in the *Bruun* case was not in point, because in that case the year in which the value of the improvements was held to be income was not only the year of the recovery of possession on lease forfeiture, but likewise the year of lessor's acquisition of title. The Court of Appeals conceded this and then urged that this court's reversal of the *Center Investment Co.* case and of the *Wood* case compelled its action. It said:

> "The distinction might be argued, were it not for subsequent action of the Supreme Court. After decision of Helvering v. Bruun, supra, the Supreme Court granted certiorari and reversed Commissioner v. Center Investment Co. and Commissioner v. Wood." (116 Fed. (2d) 329.)

May we respectfully suggest the possibility that this court, in granting certiorari and reversing the *Center Investment Co.* case and the *Wood* case, recognized their similarity to the *Bruun* case in its principal facts, but overlooked the distinguishing fact that in the *Bruun* case the acquisition of title and the termination of the lease were in the same taxable year, in fact simultaneous, which was not so in the *Center Investment Company* and *Wood* cases.

(3) Reasoning Which We Believe Supports the Trial Court's Decision in the Present Case and Is Entirely Consistent With This Court's Decision in the Brunn Case.

Assuming, as in the case at bar, that the improvements became the property of the lessor in a year

prior to the surrender of the lease, the value of the improvements would be income to lessor, at one of three points, namely:

(1) When lessor acquired title to the improvements, or

(2) When the lease was surrendered and lessor went back into possession, or

(3) When lessor obtained "in pocket" realization of the value, on the sale of the improved premises.

It would seem, from a practicable business standpoint, that of the three, the *least likely* point of income would be under *"2"*,—when the lease was surrendered.

When title to the improvements was acquired as in *"1"*, lessor had an enhancement of value which he could reduce to possession by an immediate sale if he saw fit, because the very adding of the improvements gives to the lessor an additional security for the rental term and insures him a greater opportunity of replacing the tenant under a suitable rent than he would have had if the property were unimproved. When lessor finally sold the improved property as in *"3"*, he had the enhancement in bankable form. But when, as in *"2"* he recovered possession under lessee's surrender of the lease, all he received was the obligation of searching out a new tenant, with the prospect of a reduced rental, particularly where the surrender of possession was due to rental default. It would seem that an improved lot with a rent paying lessee, is

worth more on the market, than the same property at the moment the tenant has defaulted.

Doubtless this was why the Courts of Appeal of the various circuits, prior to this court's reversing of the *Center Investment Co.* and *Wood* cases, selected either "1" or "3" as to the point of income and were in agreement with each other and with this court's decision in the *Blatt* case, that point *"2"* was not the point of income.

CONCLUSION.

Since:

(1) Under the statutory law of California, the *hotel building* constructed on petitioner's land by its lessee prior to the adoption of the income tax amendment, immediately became petitioner's property, with the right in petitioner to sell it with the land under it at any time thereafter; and

(2) Under the number of decisions of this court cited hereinabove, the fact that the increased value of the improvements "accrued" before the income tax law went into effect, prevented the taxing of that value under the Act,

we deem it reasonable to suggest that the reversal of the trial court's judgment was error, and to pray of this court the issuance of the writ to correct that error.

In view of the facts:

(1) that both the hotel building (erected in 1912) and the garage building (erected in 1915)

became, under the statutory law of California the property of petitioner in years *prior* to the surrender of the lease in the taxable year 1933, and,

(2) that the Circuit Court of Appeals' decisions and that of this court in the *Blatt* case were (prior to the *Bruun* decision of this court) in agreement that the value of improvements on a lessor's land placed thereon by its lessee, did not constitute income to a lessor in the year of the termination of the lease, by the mere fact of termination; and,

(3) that in the *Bruun* case this court had before it *solely* the question of whether there was income to lessor in the year in which lessor received title to the improvements and a surrender of the lease simultaneously, and was not at all concerned with whether the value of improvements was income in the year of acquisition of title *or* in the year of the surrender of the lease, and finally,

(4) that this court granted certiorari and reversed judgments in *Commissioner v. Wood* (*supra*) and *Commissioner v. Center Investment Co.* (*supra*), in each of which cases the years of acquisition of title and lease surrender were different; and did so on the expressed assumption that the *Bruun* decision was decisive of the matter;

we respectfully submit that the writ should issue here, so that Courts of Appeals may hereafter be guided not only by this court's direct decision in the matter, but

may also have the benefit of this court's reasoning thereon.

Dated, San Francisco, California,
May 19, 1941.

Respectfully submitted,
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BRIEF FOR THE RESPONDENTS IN OPPOSITION

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321809—41

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 107

POPE ESTATE COMPANY, A CORPORATION, PETITIONER

v.

JOHN V. LEWIS, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE FIRST COLLECTION DISTRICT OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court of the United States for the Northern District of California, Southern Division, wrote no opinion. The opinion of the Circuit Court of Appeals (R. 88–93) is reported in 116 F. (2d) 328.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Ninth Circuit was entered on December 17, 1940, and its order denying the petitioner's petition for rehearing was entered March 7, 1941 (R. 93–94).

The petition for a writ of certiorari was filed May 26, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer derived income upon the default of a lessee who had erected buildings on the taxpayer's property under the terms of a long-term lease.

STATUTE INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

STATEMENT

The taxpayer, a California corporation (hereafter called the lessor), executed a lease on March 18, 1909, of a parcel of real property for a term of fifty years from February 1, 1909, at a stipulated rental (R. 3, 9, 68). The lease provided that it might be terminated upon default in the payment

of the rental when due and if such default should continue for ten days (R. 14). As obligated by the lease, the lessee completed the construction of a hotel building in 1912, and of a garage in 1915 on the premises. In 1933, the lessor terminated the lease for default by the lessee in the payment of the rental specified in the lease (R. 68–69).

The lessor filed its income tax return for the year 1933 on the cash basis (R. 32, 40), but did not include any income derived from the forfeiture of the lease. The Commissioner of Internal Revenue determined a deficiency (R. 69, 70), which the lessor paid (R. 72). Thereafter taxpayer brought this action to recover the amount so paid.

The District Court held that the buildings erected on the lessor's land became the property of the lessor upon completion in 1912 and 1915 and that the lessor had received no income in 1933 from the buildings (R. 69). Judgment was entered for the lessor (R. 76–77), the Government appealed (R. 78), and the court below reversed (R. 93).

ARGUMENT

The court below properly held that the taxpayer's contention is foreclosed by *Helvering* v. *Bruun,* 309 U. S. 461. Taxpayer relies on two distinctions: (1) that the California Civil Code provides that improvements affixed to leased land become the property of the owner of the land (R. 89), and (2) that one of the buildings was constructed prior to the Sixteenth Amendment.

In both *Helvering* v. *Center Investment Co.*, 309 U. S. 639, and *Helvering* v. *Wood*, 309 U. S. 637, the lessors acquired title to the improvements immediately upon completion. Both cases were decided upon the authority of the *Bruun* decision and they dispose of taxpayer's first suggested distinction.

The fact that one of the buildings was constructed prior to the Sixteenth Amendment is of no consequence. What has been taxed here is the value of the new rights flowing to the taxpayer from the cancellation of the lease after the adoption of the Sixteenth Amendment. When the hotel was erected in 1912 the lessee had the exclusive right of possession and enjoyment until the expiration of the lease in 1959, unless taxpayer exercised its right to cancel the lease in 1934 and pay from 50 to 65% of the value of the buildings then on the premises (R. 15). The lease further required the taxpayer to pay 50% of the value of any "Class A" building erected by the lessee and remaining on the premises in reasonably good condition at the expiration of the lease (R. 16). Upon cancellation of the lease in the taxable year taxpayer acquired for the first time the valuable property rights which are the subject of the tax in question. *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, and *Hays* v. *Gauley Mt. Coal Co.*, 247 U. S. 189, are clearly not in point here. The rights accruing to taxpayer upon cancellation of the lease were created during the taxable year and there is, therefore,

no problem of allocating a gain accruing partly before and partly after the adoption of the Sixteenth Amendment. Cf. *United States* v. *Safety Car Heating Co.*, 297 U. S. 88.

CONCLUSION

The decision below is in accord with established principles and presents no occasion for review by this Court. The petition should be denied.

Respectfully submitted.

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JUNE 1941.

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